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IRS Uncertain Over Tax Treatment of OREO Costs

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The Internal Revenue Service released two internal advice memoranda this week regarding the proper treatment of expenses incurred by banks and other financial institutions[1] in connection with "Other Real Estate Owned" ("OREO") properties for federal income tax purposes. Field Attorney Advice Memorandum 20123201F (the "FAA") concluded that §263A of the Internal Revenue Code of 1986, as amended (the "IRC") required a bank holding company to capitalize the direct costs and an allocable share of the indirect costs associated with its OREO properties. However, IRS Advice Memorandum AM 2013-001 (the "AM"), advised that §263A did not apply to a loan-originating bank that acquires the OREO property through foreclosure or deed-in-lieu of foreclosure if the bank promptly resells the property without improvements. Capitalization generally is less favorable to taxpayers than a deduction because rather than reducing taxable income by the full amount of the expense in the current year, the expense must be recovered ratably over the life of the asset through depreciation or by reducing the amount of capital gain incurred when the asset is sold. Given the increasing amount of OREO property held by financial institutions and the accompanying increase in carrying costs, the IRS' position with respect to the proper tax treatment of OREO expenses may have a significant impact on a financial institution's tax liability.

The FAA described the following set of facts: X, a publicly traded bank holding company, generally acquires title to OREO properties through foreclosure or by "deed in lieu of foreclosure." X's OREO carrying costs have been increasing due to the increase in the number of OREO properties acquired in recent years. These carrying costs include real estate taxes (some incurred pre-acquisition but paid after the acquisition), insurance, repairs, maintenance, capital improvements, professional fees, and utilities. As had been its usual practice, X deducted the number of its OREO expenses for the year in question as "Other Deductions" on Line 26 of its Form 1120. The IRS proposed to adjust X's taxes by requiring that its OREO expenses be capitalized rather than deducted currently.

The Office of Chief Counsel reviewed the agent's request for assistance and determined that the agent had correctly adjusted the taxpayer's return. The FAA concludes that X is subject to IRC §263A. If §263A applies, the taxpayer must capitalize both the direct costs of acquiring the property and the property's allocable share of indirect costs. Treas. Reg. §§1.263A-1(a)(3)(iii), 1.263A-3(a)(1).

Section 263A applies to property that is acquired for resale. According to the FAA's analysis, property is considered acquired for resale if it is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business as described in IRC §1221(a).

The FAA further states that whether property is being held primarily for resale in the ordinary course of business is determined by looking at all of the relevant facts and circumstances. In the FAA, it was determined that X was holding the property primarily for sale to customers in the ordinary course of its trade or business based on the following facts: (a) X clearly acquired the property with the intent to resell because bank regulators restrict the holding period for OREO and expect banks to exercise good faith to sell the property; (b) X advertises its OREO properties for sale, and (c) X's annual report states that X may foreclose on and take title to properties securing loans "during the ordinary course of business." The FAA cited IRS Revenue Ruling 74-159 and the Tax Court decision in *Girard Trust Corn Exchange Bank v. Comm'r*, 22 T.C. 1343 (1954), as further support for its conclusion that the property acquired in foreclosure was property held for sale to customers in the ordinary course of business.

Based on its determination that the property was acquired for resale, the FAA concludes that X should have capitalized not only the acquisition costs of its OREO properties but also the indirect costs which are properly allocable to them. Indirect costs are "properly allocable to property" acquired for resale when the costs are incurred by reason of the performance of resale activities. Treas. Reg. 1.263A-1(e)(3)(i). Examples of indirect costs which must be allocated and capitalized include property taxes, repairs and maintenance, indirect materials costs, insurance, utilities, costs of employees and independent contractors, and service costs (e.g., the costs of administration and coordination of resale activities, legal and accounting services). These allocated costs must be added to the basis of the OREO rather than deducted when incurred.

The AM, which responded to a request for generic legal advice and was not issued with respect to the audit of a particular taxpayer, reached the opposite conclusion. The facts in the AM were substantially the same as those presented in the FAA, with a bank acquiring property through foreclosure or deed-in-lieu of foreclosure and offering that property for sale to customers. The AM limits its analysis to the tax treatment of OREO expense incurred by the financial institution originating the loan that was secured by the OREO property. In addition to noting that bank regulatory rules require banks to sell the property within certain time frames, the AM also found it significant that to the extent that a bank sells OREO property for more than the outstanding amount of the note, the excess proceeds must be turned over to the borrower because the bank is prohibited from selling property for profit.

Unlike the FAA, the AM concludes that the OREO property is not acquired for resale and, therefore, §263A does not apply. The AM relies upon an exception to the definition of resale activity in reaching its conclusion. Under the Treasury Regulations, a bank's activity of originating loans is not considered the "acquisition of property for resale" within the meaning of IRC §263A. Treas. Reg. §1.263A-1(b)(13). The AM reasons that where the bank takes the title and disposes of the OREO property as a means of mitigating its loss, and not as a for-profit activity, the bank's actions are an extension of its loan origination activity. Accordingly, the AM concludes that the OREO property is not acquired for resale and, therefore, the capitalization rules of IRC §263A do not apply. While the conclusion reached in the AM is very taxpayer friendly, the extension of the "loan origination" exception to cover resale of OREO properties does not appear to be supported by, and the author did not cite as authority for its conclusion, the language of the statute or the regulations or any administrative or judicial decisions.

Internal advice memoranda released by the IRS are not binding upon the IRS and may not be relied upon by taxpayers. The issuance of these conflicting memoranda evidence that deductions for OREO carrying costs are raising red flags with IRS field agents and that the IRS has yet to reach a definitive conclusion as to their proper treatment. Financial institutions should expect that, until definitive guidance is issued with respect to the tax treatment of OREO carrying costs, on audit the IRS may continue to challenge returns where OREO expenses are deducted rather than capitalized. We will continue to monitor this issue for further administrative or judicial guidance.

Please contact Deirdre Mitacek at 516-296-9136 or dmitacek@cullenanddykman.com if you have any questions regarding the proper tax treatment of the costs associated with OREO properties held for resale.

1. While both the FAA and the AM addressed factual situations involving banks, the reasoning in both memoranda would extend to other financial institutions as well.

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